Subcommittee on Aviation Hearing on The Financial Condition of The Airline Industry

Testimony of Jeff Potter, President & CEO Frontier Airlines, Inc.

June 3, 2004

Chairman Mica, Congressman Oberstar, Congressman Beauprez, and Members of the Subcommittee on Aviation: Thank you for providing the opportunity to testify on the state of the U. S. airline industry. As you all know, this industry has undergone significant changes since September 11, 2001. Those airlines that have been able to make necessary adjustments and meet the changing demands of travelers have become stronger. Those who continue to act, and even react, as if things have not changed, have suffered.

Brief Background on Frontier

This Committee has taken important steps to maximize consumer options and to expand service throughout the country and Frontier Airlines is a contributor towards those efforts. Beginning operations in July 1994, this summer we are celebrating our tenth anniversary. During the past ten years, we have grown from an airline with two aircraft serving four cities from its Denver hub, to an airline with 42 mainline aircraft, and nine 70-seat regional jets operated by our code share partner Horizon Air, serving 48 cities in the United States and Mexico. In addition, our system reaches an additional 32 cities throughout the Rocky Mountain region through a relationship with Great Lakes Aviation, which operates turbo-prop aircraft. In total, these combined services reach 80 communities, large and small, throughout the United States. Service to these communities is an integral part of Frontier Airlines and many would not have a low fare air service alternative if not for these arrangements.

Frontier has grown from 180 employees to over 4,300 today, and is proud to have become Denver's second largest air carrier with a 17.9 percent market share.[1] During this past year alone, Frontier's capacity grew by almost 19 percent while the number of customers we carried increased almost 42 percent. These statistics demonstrate the tremendous response to our comfortable product, friendly service and low fares, all of which combine to fuel our growth and expansion, primarily at Denver International Airport ("DIA").

Prompt Response to the Events of September 11

We are where we are today in part because of the strength and support of the Denver and Colorado community and the contributions of our employees, who are dedicated to provide efficient, safe air travel to our customers in a friendly and professional manner.

In response to the terrorist attacks of September 11, 2001, Congress passed and President Bush signed into law on September 22, 2001, the Air Transportation Safety and System Stabilization Act (the "Act"). This the Act provided $5 billion in grants to compensate air carriers for the direct losses incurred as a result of the Federal ground stop order and incremental losses that were incurred by the airlines through December 31, 2002 as a result of the terrorist attacks.

[1] Source: Denver Int'l Airport - Market share based on percentage of overall revenue passengers at DIA for March of noted year and included Jet Express passenger statistics.

Like all airlines at the time, Frontier took immediate steps to cut costs to offset the dramatic drop in demand for air travel that followed the tragic events of September 11, 2001. Frontier developed a plan with our employees and vendors to restructure certain elements of our financial obligations. We cut the salaries of the Company officers by 20 to 40 percent. Salaries were reduced between 3 and 15 percent for another 650 employees. We reduced our workforce -- through attrition, leaves of absence, early retirements and select reductions in force -- by approximately 405 employees, or almost 14 percent of our total full and part time workforce. Our schedule was reduced by approximately 20 percent as we grounded four aircraft. Frontier's losses arising directly out of the events of September 11 were significant and demonstrable. Out of the $5 billion grant funds authorized by the Act, Frontier received $12.8 million based on our capacity as a percentage of the domestic airline industry as of August 2001. Some airlines received almost $800 million under this authority. Yet Frontier was one of only a handful of airlines that paid taxes on this grant.

Prior to September 11, Frontier had been able to weather the difficulties of our sluggish economy. Even during the Company's fiscal quarter ending September 2001, Frontier was able to post its 14th consecutive profitable quarter. While Frontier also posted net income during its fiscal quarter ending December 2001, the full effect of the attacks of September 11 and the decline in passenger traffic was felt. Without the gain from the first installment of the $12.8 million grant, net of taxes, the Company would have posted a $1.4 million loss. The Company also posted consecutive quarterly losses from June 2002 through March 2003 as the effects of September 11 continued to stall the United States economy and the airline industry in particular.

Despite these tough times, however, I'm proud to say that, due to management's quick response to the events of September 11, the dedication of our employees, and the ability to mitigate losses, Frontier Airlines became the only airline to repay any portion of the grant funds received when it returned approximately $4.8 million to the Federal Government.

Support from the Air Transportation Stabilization Board and Commercial Markets

The Act also authorized the issuance to air carriers of Federal credit instruments to assist air carriers who suffered losses due to the terrorist attacks of September 11, 2001. The Act established the Air Transportation Stabilization Board ("ATSB"), which was empowered to enter into agreements to issue these loan guarantees and other Federal credit instruments.

On June 28, 2002, the deadline, Frontier applied for a $70 million loan, of which $63 million was to be guaranteed by the ATSB. Frontier received conditional approval on November 5, 2002 and on February 14, 2003, Frontier obtained final approval and payment of the loan proceeds. Frontier was awarded this guarantee by the ATSB, as approved by Congress and the President, based on the Company meeting the following criteria:

- Frontier's request was based on losses incurred as a direct result of the terrorist attacks on the United States on September 11, 2001,
- Credit was not otherwise reasonably available at the time of the loan, and
- Frontier presented a sound business plan that demonstrated its ability to repay the loan.

The term of the guaranteed loan was just over 52 months, with a final maturity date of June 30, 2007. Frontier made a required loan prepayment of $10 million in July 2003 as a result of its receipt of a federal tax refund.

In the year after receiving the loan, Frontier Airlines' unit cost ("CASM"), excluding fuel, was reduced by 1.6 percent. During the same period, Frontier's unit revenue ("RASM") increased by 13.2 percent. Load factor, or percentage of our seats occupied by a customer, increased 11.7 points.[2] The RASM improvement led the industry on a year over year basis.

Frontier's sound business plan, supported by a vote of confidence from the ATSB, and the Company's ability to achieve these improved economic results, enabled Frontier to approach the equity markets with a secondary offering of common stock in the Fall of 2003. Substantially oversubscribed, the Company was able to increase the amount of the offering in the final days to over 5 million shares and obtain a net equity investment of just over $81 million. From these funds, Frontier made a second guaranteed loan prepayment of $48.6 million in September 2003. The equity offering enabled Frontier to reduce its adjusted debt to capitalization ratio to below 80 percent.

Proudly, on December 22, 2003, Frontier presented the members of the Colorado Congressional delegation, including Congressman Beauprez, with an oversized check in the amount of $11.6

[2] It is important to recognize that the consumer benefit of Frontier's growth and LCC growth in general, is lower fares. As I mentioned, our unit revenue increased this past year, but our average fare actually declined from $109 to $104, a 4.6 percent decrease, and a benefit to the traveling public.

million, representing the repayment of the final outstanding balance of the $70 million guaranteed loan.

Our ability to repay the ATSB loan in ten months, almost four years early, was accomplished through the Company's commitment to a simple and proven business plan involving a low cost structure and everyday low fares. The vote of confidence provided by the ATSB, and particularly the recognition by the commercial equity markets, confirmed the soundness of the Company's business plan.

The Role of Low-Cost Carriers

Not only has Frontier's growth increased competition and provided the traveling public a low fare alternative when planning their travel to and from Denver, but the Low Cost Carriers ("LCCs") are growing faster at DIA than at any of the nation's ten busiest airports.[3] Based on an airport study conducted by the Air Service and Marketing department at DIA, Denver realized the highest growth rate among the top U.S. airports in both flight and seat departures on LCCs since 2001. The number of flight departures from Denver on LCCs in 2003 increased by 65.3 percent over 2001, and the number of seats from Denver on LCCs increased by 51.7 percent over this same time period.

[3] The U.S. Department of Transportation has designated seven carriers as low cost: AirTran, America West, ATA, Frontier, JetBlue, Southwest and Spirit. All of these carriers, with the exception of Southwest, currently operate at DIA. These six LCCs serve almost 50 destinations with nonstop service and carried nearly 20 percent of DIA's passengers in 2003. DIA has welcomed three low-cost carriers in the past three years. JetBlue began service in May 2001, Spirit in May 2002, and AirTran in May 2003.

Not only do these carriers provide airline choice to passengers using DIA, but their growth in the industry has helped lower fares in Denver as well. Denver's average fare dropped 23 percent in two years - from $189 for the year ending June 2001 to $145 for the year ending June 2003. The Air Service and Marketing department at DIA characterized the primary contributing factor behind the fare reduction this way: "We attribute the fare decline to increased competition as a result of low-cost carriers entering into and growing in the Denver market."

In highlighting why there has been such a dramatic increase in the LCC service in Denver, the report mentions the following factors:

- Need for fare discipline in the market.
- With United's fortress hub at Denver, fares to many markets were artificially high.
- Competition by LCCs has helped to lower the average fare at Denver.
- Average fare at Denver now ranks 12th in the nation (Fourth Quarter 2002) which is down from 6th highest in the nation (Fourth Quarter 2001).
- Economies of scale realized by Frontier Airlines with their growth over the past several years.

The benefits of LCC growth at DIA is only an example of the benefits LCCs provide nationwide when they are able to expand their services and bring low fares to an increasing number of new markets. This growth, however, is accompanied by challenges and barriers. The most onerous is the continued rise in fuel costs and other fees associated with airline operations as well as facility constraints.

The Impact of Rapidly Rising Fuel Prices and the Burden of Excessive Taxes

During the past year, while our overall costs have declined, our fuel costs have increased 8.3 percent from $.98 per gallon to $1.04 per gallon. This cost continues to escalate. During the March quarter our cost was $1.17 per gallon. For each one-cent increase per gallon, our costs increase approximately $1.4 million on an annual basis. Last year our fuel expense was 17 percent of our total costs. In the March 2004 quarter, fuel expense rose to represent 20 percent of our overall operating costs.

Taxes also impose a significant burden on airlines. When an airline ticket is sold, the taxes and fees paid from that ticket are among the highest in any service industry. If you were to purchase a $200 round-trip ticket from Atlanta to Los Angeles, connecting through DIA, the taxes and fees equal 26 percent of the ticket price.[4] Therefore, while the passenger is paying $200, the airline only receives $148.

Congestion and Facility Constraints

Concerns about congestion are not new to the airline industry. As far back as 1968 significant congestion and delays at some airports led the FAA to establish the high density rules. Although intended to be a temporary solution, thirty-five years later we still find high density rule slot

[4] This assumes a passenger facility charge of $4.50 at each of the three airports.

restrictions in place. The FAA also held scheduling meetings in 1984 and 1987 because of concerns over congestion and delays impacting our nation's air transportation system.

Much has already been said about how security screening facilities and staffing issues contribute to airport delays. At DIA, our hub, we have already been told by airport authorities that auxiliary security staff will be hired to augment TSA personnel to avoid security delays this summer. The cost of these additional personnel will of course be passed along to the airlines.

Aside from security screening, however, we believe there are two other factors that contribute greatly to congestion and delays in airport operations -- the inefficient use of existing airport facilities and the increasing reliance by major airlines on regional jets. Certainly, before Congress and the taxpayers, and even the airlines, are asked to contribute to the expansion of existing airport facilities, it would be prudent to ensure that the existing facilities are being used to their maximum efficiency.

Inefficient Use of Facilities Promotes Congestion

The problem primarily arises at hub airports, where major airlines seek to control as much of the facility as possible in order to limit competition. A brief summary of our own experience at DIA, serves as a good example.

In 1999, United Airlines leased 43 gates at DIA to accommodate 307 daily mainline departures, for an average of just over 7 mainline departures per leased gate. By 2002, prior to filing for bankruptcy protection, United decreased its level of service by 38 departures, to a total of 269. The following year, United decreased its level of service by 18 more daily departures, to a total of 251 – a total decrease of over 18 percent from its 1999 level. Yet at the same time it increased the number of gates it controlled by eight, to a total of 51 – an *increase* of over 18 percent. In 2003 United averaged fewer than 5 departures per leased gate. By comparison, Frontier has typically averaged at least 7.5 mainline departures per leased gate.

When the City and County of Denver was renegotiating its lease with United as part of United's bankruptcy process, based on United's decreased capacity at DIA, we urged the City to have United release eight gates located on Concourse A to accommodate the growth of other airlines. United refused.

Retaining these gates despite the decrease in departures was an expensive decision. Airports charge airlines annual fees based, at least in part, on the number of gates and other square footage the airline leases. The annual fees are often expressed as a dollar charge per enplaned passenger. In 2002, United paid DIA $17.50 per enplaned passenger in total fees. By comparison, in 2002 Frontier paid DIA $9.47 per enplaned passenger in total fees. During the bankruptcy proceeding, United had the option to restructure its lease, reduce its facilities, and reduce its operating costs at DIA. However, DIA estimates United will pay $18.05 per enplaned passenger in 2004, an *increase* of 55 cents over the rates it paid prior to restructuring its lease.[5] With United boarding an estimated 9.7 million passengers at DIA in 2004, that means it was willing to pay an additional $5.5 million in fees, $3 million of which DIA estimates is

[5] This rate reflects the savings attributed to United's agreement to provide Frontier three gates on a temporary basis.

attributable to the eight gates on Concourse A, rather than return gates to DIA for use by other airlines.

While blocking expansion by other airlines is expensive for United, it is also costly to the taxpayers. Because of United's refusal to consolidate its operations, DIA is being forced to undertake an expansion project estimated to cost near $100 million in order to accommodate growth by other carriers.

Regional Jets Also Congest Airports

So far I have only presented information relating to mainline operations. As I mentioned at the outset, the efficient use of airports is also impaired by the substantial increase in regional jet operations. While these jets flow into this country's airspace and airports, they do so with fewer seats and less passenger convenience.

Again looking at DIA, regional jet departures at DIA have grown from 53 in 1999 to 152 in 2004. At United, regional jets now account for about 30 percent of its daily departures from DIA. And the airline has recently announced its intention to increase regional jet operations at DIA up to 45 percent of its total departures in years to come.

With limited space, many of these regional jets will need to use gates and other facilities designed for larger aircraft. Of the 152 daily regional jet departures at DIA today, we estimate about 50 percent depart from a mainline gate. As regional jet operations increase, it will only place more strain on the limited space available at this country's airports and in its airspace for full-size commercial jet aircraft.

Our facility constraints are in no way limited to DIA. In fact, of the 47 cities that we serve today, we have 14 markets where we rely on other airlines to handle our operations. Of those markets, eight have facility limitations that haven't allowed for our pursuit of reducing our cost of operating and improving our customer service by having our own employees handle our flights and work directly with our passengers.

Need for Government Monitoring and Control

We believe the government must take an active role in supervising the efficient use of this country's limited aviation resources. Unfortunately, as we demonstrated above, airlines will not always make decisions based on efficiency and sound economic practices.

The Department of Transportation, with guidance from Congress if necessary, should expand the scope of competition plans currently prepared by certain of our nation's larger airports to include a description of how airport facilities will be managed to maximize efficient use. Requiring a specific number of mainline departures per leased gate, or allocating gates based on the number of passengers per departure, and limiting or prohibiting regional jets from using mainline gates and facilities, will cause all air carriers to develop business plans and schedules that make maximum use of this nation's existing airport infrastructure. Only after we make sure that existing facilities are being used to their maximum should we consider costly expansions in order to alleviate congestion and delays in our nation's air transportation system.

We support actions taken to promote efficiency and cut costs but government must not further block competition in what is supposed to be an open and level marketplace. To the extent Congress addresses the financial and operational issues facing the airline industry, it should do so in a manner that will benefit all airlines equally and preserve a level playing field for all concerned.

Chairman Mica, once again, I want to thank you and all the members of the Subcommittee on Aviation for this opportunity to speak about some of the many challenges this industry is facing and I look forward to answering any questions you may have.